CFTC FINAL RULES ON PROTECTION OF CLEARED SWAPS CUSTOMER CONTRACTS AND COLLATERAL, AND CONFORMING AMENDMENTS TO THE COMMODITY BROKER BANKRUPTCY PROVISIONS

January 24, 2012

To Our Clients and Friends:

On January 11, 2012, the Commodity Futures Trading Commission (the "CFTC") adopted final rules (the "Final Rules") to implement section 724 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which provides for the treatment of cleared swaps[1] and related collateral before and after the bankruptcy of a futures commission merchant ("FCM").

Section 724(a) of the Dodd-Frank Act amended the Commodity Exchange Act (the "CEA") by adding new section 4d(f), which provides for the protection of collateral ("Customer Collateral") deposited by cleared swaps customers[2] ("Customers") to FCMs and derivatives clearing organization ("DCO"). To implement section 4d(f) of the CEA, the Final Rules add Part 22 to the CFTC regulations (the "Regulations"), which governs the protection of margin posted by Customers to FCMs and DCOs and related reporting and recordkeeping requirements. In addition, section 724(b) of the Dodd-Frank Act amends Title 11 of the U.S. Code (the "Bankruptcy Code") to clarify that cleared swaps are "commodity contracts" in relation to FCMs and DCOs and that associated Customer Collateral, when deposited by Customers, will be subject to the protection of the Bankruptcy Code and Regulation Part 190. The Final Rules amend Regulation Part 190 to implement section 724(b) of the Dodd-Frank Act.

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[1] *Regulation 22.1 defines "cleared swap" as, for purposes of Part 22 only, (a) excluding any swaps (and related collateral) that, pursuant to a CFTC rule or regulation or derivatives clearing organization ("DCO") rule, are commingled with futures contracts (and related collateral) in a customer account established for the futures contract and (b) including any futures contacts or foreign futures contracts (and related collateral) that, pursuant to a CFTC rule or regulation or DCO rule, are commingled with swaps (and related collateral) in a Customer Account established for the cleared swap.*

[2] *Regulation 22.1 defines "cleared swaps customer" as any person entering into a cleared swap, excluding any owner or holder of a cleared swaps proprietary account (as described below) with respect to the cleared swaps in such account and a clearing member of a DCO with respect to cleared swaps cleared on that DCO.*

TREATMENT OF CUSTOMER CONTRACTS AND CUSTOMER COLLATERAL

New section 4(d)(f) of the CEA and the Final Rules impose certain new requirements on FCMs and DCOs regarding the treatment of cleared swaps of Customers and Customer Collateral.

Segregation Models

In the proposed rules,[3] the CFTC considered a number of different models for the protection of Customer Collateral transferred to FCMs and DCOs and invited the public to comment on such models.[4] In the Final Rules, the CFTC has determined to use the "legal segregation with

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[3] *Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 76 Fed. Reg. 111 (June 9, 2011) (to be codified as 17 C.F.R. parts 22 and 190).*

[4] *A brief description of each proposed model follows:*

Legal Segregation with Recourse Model. It is similar to the "legal segregation with operational commingling" model (the "LSOC Model"), which the CFTC has adopted under the Final Rules. Under the legal segregation with recourse model, each FCM and DCO would segregate the cleared swaps of each individual Customer and Customer Collateral on its books and records and would be permitted to commingle the Customer Collateral in one account, provided that such account is separate from any cleared swaps proprietary accounts or property belonging to persons that are not Customers. Unlike the LSOC Model, following a situation where a Customer experiences a loss in connection with a cleared swap and defaults on a margin call from a clearing FCM, which default results in a default of the clearing FCM to meet the related margin call from a DCO (a "double default") (as more fully explained in footnote 5 below), the legal segregation with recourse model would not prohibit the DCO from accessing the Customer Collateral of the non-defaulting Customers, after the DCO applies its own capital as well as the guaranty fund contributions of its non-defaulting members to cure the default.

Full Physical Segregation Model. The full physical segregation model differs from the LSOC Model in operation only prior to a double default. Similar to the LSOC Model, each FCM or DCO would segregate on its books and records the cleared swaps of each Customer and the Customer Collateral. The main difference of the full physical segregation model from the LSOC Model is that each FCM and DCO would maintain a separate individual account for the Customer Collateral (which would result in additional costs by each FCM and DCO). After a double default, the full physical segregation model would result in the same outcome as the LSOC Model, in that the DCO would be permitted to access the Customer Collateral of the defaulting Customers, but would not be permitted to access the Customer Collateral of the non-defaulting Customers. Section 766(h) of the Bankruptcy Code requires that customer property be distributed pro rata to customers on the basis and to the extent of such customers' allowed net equity claims. In other words, in the event of an FCM default, Customers must be treated equally regardless of whether their Customer Collateral is better protected (through full physical segregation) than the property of other Customers, resulting in the same ultimate outcome using either the full physical segregation model or the LSOC Model.

Futures Model. The futures model would have replicated the segregation requirements that currently apply to futures, pursuant to which DCOs treat the Customer accounts of each FCM as belonging to an undifferentiated group of customers. The FCM would segregate on its books and records the cleared swaps of each Customer and Customer Collateral, while each DCO would view the cleared swaps on a collective basis. Under the futures model, each FCM and DCO would be permitted to commingle all Customer Collateral in one account. After a double default, a DCO would be permitted to

operational commingling" model (the "LSOC Model") as the segregation model for the cleared swaps and Customer Collateral. In the release accompanying the Final Rules (the "Release"), the CFTC explains that it believes that the LSOC Model provides the most appropriate framework for the protection of Customer Collateral by largely mitigating the so-called fellow-customer risk[5] and providing for portability of cleared swap positions and Customer Collateral, while, at the same time, providing a good balance between the costs and adequacy of Customer Collateral protection.

As described in detail below, under the LSOC Model, each FCM and DCO must segregate, on their respective books and records, the cleared swaps and Customer Collateral of a Customer from the obligations of the FCM or DCO and the obligations of persons that is not the Customer. However, each FCM and DCO will be permitted to commingle[6] all of the Customer Collateral deposited by all Customers in one account, but such account must be separate from any account holding FCM or DCO property or the property of persons that are not Customers. In a situation where a Customer experiences a loss in connection with a cleared swap and cannot meet a margin call of an FCM which in turn causes the FCM to default on the related margin call from the DCO (a "double default"), the DCO will only be permitted to use the Customer Collateral of the Customer that defaulted, and not the Customer Collateral of any other

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access the Customer Collateral of the non-defaulting Customers before applying its own capital or the guaranty fund contributions of the non-defaulting FCM members.

Optionality Model. The optionality model would have allowed a DCO to choose to comply with any of the (a) LSOC Model or the legal segregation with recourse model, (b) physical segregation model or (c) futures model.

[5] *In the Release, the CFTC explains that "fellow-customer risk" is the risk that a DCO would need to access the Customer Collateral of non-defaulting Customers to cure an FCM default. More specifically, in the event that a Customer of a clearing FCM experiences a loss in connection with a cleared swap and defaults on a margin call from a clearing FCM (the "Defaulting Customer"), such Defaulting Customer's clearing FCM will be required to make a variation payment to the DCO that carries the Defaulting Customer's cleared swaps. The loss may exceed the sum of the FCM's available liquid assets, the Customer Collateral posted by the Defaulting Customer and any additional payments immediately available from the Defaulting Customer. In such a situation, the Defaulting Customer will have defaulted on its obligation to the clearing FCM, and the clearing FCM, as a result, will default on its obligation to the DCO (i.e., a double default). Under the current rules applicable to futures, in the event of a double default, the DCO would be permitted to access the customer collateral of the FCM's customer account to meet a loss in that account, regardless of which customer supplied the customer collateral (i.e., the non-defaulting customers of the defaulting FCM are subject to loss due to fellow-customer risk).*

[6] *Regulation 22.1 defines "commingle" as holding two or more items in the same account, or to combine such items in a transfer between accounts.*

Customers (after the DCO applies its own capital as well as the guaranty fund contributions of its non-defaulting FCM members to cure the default).

Customer Collateral

Regulation 22.1 defines "cleared swaps customer collateral ("Customer Collateral")" as all money, securities or other property received by an FCM or DCO from, for or on behalf of a Customer, which is intended to or does margin, guarantee or secure a cleared swap or constitutes, if a cleared swap is in the form or nature of an option, the settlement value of the option. This term also includes all accruals that an FCM or DCO receives which is incident to a cleared swap that an FCM intermediates for a Customer. In the Release, the CFTC clarifies that the term includes excess collateral (*i.e.*, collateral voluntarily deposited by or on behalf of a Customer in the Customer Account (as defined below) in excess of the amount required by an FCM and DCO). As to such excess collateral, the FCM may transmit it to the DCO only if the FCM is permitted to do so under the DCO's governing rules and the DCO provides a mechanism by which the FCM can identify the amount of such excess collateral attributable to each Customer and such mechanism is effective to accomplish that goal.

Cleared Swaps Customer Accounts and Cleared Swaps Proprietary Accounts

Regulation 22.1 defines "cleared swaps customer account" as any account ("Customer Account") of an FCM for the cleared swaps of Customers and Customer Collateral that such FCM maintains for its Customers or that a DCO maintains for such FCM on behalf of Customers of such FCM. Regulation 22.1 also defines "cleared swaps proprietary account" as an account ("Proprietary Account") for cleared swaps and collateral that is held on the books and records of an FCM for the FCM itself or for persons with certain relationships with the FCM (including, but not limited to, where such FCM is a partnership, limited partnership, corporation or association, any person that manages such entity, keeps records or signs checks for such entity, handles the cleared swaps of Customers or Customer Collateral, and any spouse or child living in the same household as any such person).

While a Customer Account is entitled to the protections described in this memorandum, including the protection of segregation from the property of an FCM or DCO and property belonging to persons that are not Customers, a Proprietary Account is not entitled to any such protection.

FCM Segregation

Regulation 22.2 requires an FCM to treat the cleared swaps of a Customer and related Customer Collateral as belonging to the Customer. An FCM is required to segregate the cleared swaps of each individual Customer and Customer Collateral on its books and records by either (a) depositing such Customer Collateral into one or more Customer Accounts held at a depository

that meets the requirements of Regulation 22.1 (a "Permitted Depository")[7] or, (b) if the FCM holds the Customer Collateral itself, physically separating such Customer Collateral from its own property and any property belonging to persons that are not Customers, identifying the physical location in which such property is held (the "FCM Physical Location"), ensuring that the FCM Physical Location provide appropriate protection for such Customer Collateral and recording on its books and records the amount of such Customer Collateral separately from its own funds (*i.e.*, ensuring that such entries be separate from entries indicating FCM obligations or the obligations of persons that are not Customers).[8]

In the Release, the CFTC clarifies that its 2005 Amendment to Financial and Segregation Interpretation No. 10 on the Treatment of Funds Deposited in Safekeeping Accounts does not apply to cleared swaps. Therefore, subject to certain conditions, Customer Collateral may be deposited at a bank in a third-party safekeeping account, in lieu of posting such collateral directly to an FCM, without the FCM being deemed in violation of section 4d(f) of the CEA, and an FCM is permitted to allow Customers to elect to have their Customer Collateral held in such account. However, in that case, such FCM must comply with all of the conditions for such account set forth in the original Segregation Interpretation No. 10 as issued in 1984. In addition, Customer Collateral in such account constitutes customer property within the meaning of the Bankruptcy Code and Regulation Part 190, subject to, among other things, the *pro rata* share of available customer property in case of the bankruptcy of such FCM.

DCO Segregation

Regulation 22.3 requires each DCO to treat Customer Collateral deposited by an FCM as belonging to Customers of that FCM. The DCO must segregate the Customer Collateral that it receives from FCMs on its books and records. As in the case under Regulation 22.2 described

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[7] *Regulation 22.4 states that in order for a depository to be a "Permitted Depository," it must be a bank located in the United States, a trust company located in the United States, a Collecting FCM (defined below) registered with the CFTC or a DCO registered with the CFTC. In addition, the FCM or DCO must have a written acknowledgment letter from the depository, as described in further detail below.*

[8] *In the Release, the CFTC clarifies that its 2005 Amendment to Financial and Segregation Interpretation No. 10 on the Treatment of Funds Deposited in Safekeeping Accounts does not apply to cleared swaps. Therefore, subject to certain conditions, Customer Collateral may be deposited at a bank in a third-party safekeeping account, in lieu of posting such collateral directly to an FCM, without the FCM being deemed in violation of section 4d(f) of the CEA, and an FCM is permitted to allow Customers to elect to have their Customer Collateral held in such account. However, in that case, such FCM must comply with all of the conditions for such account set forth in the original Segregation Interpretation No. 10 as issued in 1984. In addition, Customer Collateral in such account constitutes customer property within the meaning of the Bankruptcy Code and Regulation Part 190, subject to, among other things, the pro rata share of available customer property in case of the bankruptcy of such FCM.*

above, each DCO must segregate all Customer Collateral that it receives from FCMs by either (a) depositing such Customer Collateral into one or more Customer Accounts held at a Permitted Depository or, (b) if the DCO holds the Customer Collateral itself, physically separating such Customer Collateral from its own property and any property belonging to any FCM and the property of any other persons that are not Customers of an FCM, identifying the physical location in which such property is held (the "DCO Physical Location"), ensuring that the physical location provide appropriate protection for such Customer Collateral and recording on its books and records the amount of such Customer Collateral separately from its own funds, the funds of any FCM and any other persons that are not Customers of an FCM.

Commingling

Regulations 22.2(c) and 22.3(c) provide that each FCM and DCO may commingle the Customer Collateral that it receives from, for or on behalf of multiple Customers (or multiple FCMs on behalf of their Customers in the case of a DCO) in one account. However, an FCM or DCO may not commingle Customer Collateral with their own property or other categories of funds belonging to other customers of the FCM or DCO. An FCM and DCO must hold Customer Collateral in a location or account that is separate from the property belonging to such FCM or DCO.

Limitations on Use of Customer Collateral

Regulation 22.2(d) provides that an FCM may not use, or permit the use of, Customer Collateral deposited by a Customer to purchase, margin or settle the cleared swaps or any other transaction of a person other than the Customer or to margin, guarantee or secure any contract other than cleared swaps of the Customer. In addition, an FCM may not grant a lien to any person (other than a DCO) on Customer Collateral, including on any FCM residual financial interests therein. An FCM may not claim that money invested in the securities, memberships or obligations of any DCO, designated contract market, swap execution facility or swap data repository, or money, securities or other property that any DCO holds and may use for a purpose other than to margin, guarantee, secure, transfer adjust or settle the obligations of the FCM on behalf of its Customers constitutes Customer Collateral. In addition, a DCO may not hold or dispose of the Customer Collateral that an FCM receives from a Customer to margin cleared swaps in any manner that would indicate that such Customer Collateral belonged to the FCM or any person other than the Customer.

Regulation 22.15 requires each DCO and each collecting FCM[9] (a "Collecting FCM") receiving Customer Collateral from an FCM to treat the amount of the Customer Collateral as belonging to the Customer. Such amount may not be used to margin, guarantee or secure the cleared swaps or any other obligations of the FCM or any other person.

Exceptions to Rules on the Limitations on Use of Customer Collateral

Regulations 22.2(e) and 22.3(d) provide certain exceptions to some of the restrictions described above. For example, an FCM or DCO may invest Customer Collateral in accordance with Regulation 1.25 (investments of customer funds), and an FCM may also withdraw Customer Collateral for such purposes as meeting margin calls at a DCO or a Collecting FCM or to meet charges accrued in connection with a cleared swap. In the Release, the CFTC clarifies that Regulation 22.3 is intended to permit a DCO to use variation margin collected from Customers to pay variation margin to other Customers. In addition, an FCM is permitted to deposit its own capital in an FCM Physical Location or in a Customer Account. The CFTC clarifies in the Release that where an FCM has used its own capital to cure a Customer's undermargined or deficit account, the DCO may use such collateral to meet a default by a Customer to the same extent as if such Customer had provided the collateral. Where an FCM has used its own capital to create a buffer in a Customer Account which does not belong to any specific Customer, such collateral is not restricted to any specific Customer for any permitted access by the DCO. Finally, if an FCM deposits its own capital in an FCM Physical Location or in a Customer Account, the FCM is permitted to retain a residual interest in the property in excess of the amount necessary to meet the segregation requirements under Regulation 22.2.

In the Release, the CFTC also clarifies that a Customer may grant a lien on its Customer Account with an FCM Also, an FCM is permitted to take a security interest in the Customer Account of its Customer in support of other positions held by such Customer at the FCM, and other entities (including affiliates of an FCM) are permitted to take a security interest in the Customer Account of a Customer in support of financing the Customer's margin obligations.

Account Computations

The Final Rules provides that each FCM must compute on a daily basis the aggregate market value of the Customer Collateral held in all FCM Physical Locations or at a Permitted Depository, the sum of any credit balances that the Customers of such FCM have in their accounts (excluding any debit balances that the Customers of such FCM have in their accounts)

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[9] *Regulation 22.1 defines "collecting futures commission merchant" as an FCM that carries cleared swaps on behalf of another FCM and the Customers of such FCM, that, as part of carrying such cleared swaps, collects Customer Collateral.*

and the amount of the residual financial interest that the FCM holds in such Customer Collateral.

Written Acknowledgments

Regulation 22.5 states that prior to depositing Customer Collateral into a Permitted Depository, an FCM or DCO must obtain a written acknowledgment letter from each depository (including depositories located outside of the United States). In the Release, the CFTC explains that the written acknowledgement is intended to establish the commercial expectations of the parties before a bankruptcy event. In addition, Regulation 22.5 requires each FCM or DCO to comply with the requirements set forth in Regulations 1.20 (customer funds to be segregated and separately accounted for) and 1.26 (deposit of instruments purchased with customer funds) with respect to the retention, access, filing and amendments of such acknowledgment letter, as if the Customer Collateral comprised customer funds subject to segregation pursuant to section 4d(a) or 4d(b) of the CEA and regulations thereunder. Notwithstanding the above, a DCO is not required to obtain an acknowledgement letter if such DCO has effected rules that provide for the segregation of Customer Collateral in accordance with the CEA and regulations thereunder.

Site of Customer Accounts

Under Regulation 22.8, each FCM Physical Location and DCO Physical Location must be located in the United States. Likewise, each account that an FCM maintains for a Customer and each Customer Account on the books and records of a DCO with respect to the Customers of an FCM must also be located in the United States. In the Release, the CFTC notes that in the event of an FCM's bankruptcy, Regulation 22.8 is intended to make clear that the insolvency regime that will apply to Customers of the FCM is that of the Bankruptcy Code and Regulation Part 190.

Denomination of Customer Collateral and Location of Depositories

Regulation 22.9 provides that an FCM and DCO are permitted to hold Customer Collateral in the denominations, at the locations and depositories and subject to the segregation requirements set forth in Regulation 1.49 (denomination of customer funds and location of depositories), which regulation will apply to Customer Collateral as if it comprised customer funds subject to segregation pursuant to section 4d(a) of the CEA. Notwithstanding Regulation 1.49, an FCM's obligations to a Customer may be denominated in a currency in which funds have accrued to the Customer as a result of a cleared swap carried through such FCM.

Providing Information Regarding Customers and their Cleared Swaps

Regulation 22.11 requires that a depositing FCM[10] (a "Depositing FCM") provide to its Collecting FCM the first time it intermediates a cleared swap for a Customer and at least once each business day thereafter, (a) information sufficient to identify such Customer and (b) information sufficient to identify the portfolio of rights and obligations arising from the cleared swaps that such Collecting FCM intermediates for such Customer. Also, an FCM that intermediates a cleared swap for a Customer, subject to the rules of a DCO, directly as a clearing member must similarly provide to its DCO the same items of information as a Depositing FCM provides to its Collecting FCM. Certain additional information requirements apply if an FCM serves as both a Depositing FCM and a Collecting FCM or if an FCM that is a clearing member of a DCO is also a Collecting FCM. In addition, each DCO must ensure that an FCM provide the required information described above and confirm that such information is accurate and complete. In the Release, the CFTC explains that a DCO does not have a responsibility to monitor the nature or amount of Customer Collateral posted by a Customer with an FCM, but the DCO should instead take appropriate steps to verify that FCM members are using appropriate procedures to accurately track the positions of each Customer.

Maintaining Information Regarding Customer Collateral

Regulation 22.12 requires that (a) a Collecting FCM that receives Customer funds from an entity serving as a Depositing FCM and (b) a DCO that receives Customer funds from an FCM must, in each case, calculate and record at least once each business day (i) the amount of Customer Collateral required at such Collecting FCM or DCO, as applicable, for each Customer of the entity acting as Depositing FCM (including each Customer of any Depositing FCM for which such entity also serves as a Collecting FCM) in the case of the Collecting FCM or an FCM in the case of the DCO and (ii) the sum of such individual Customer Collateral amounts. A Collecting FCM (in dealing with a Depositing FCM) or an FCM (in dealing with a DCO) must calculate the Customer Collateral amounts described in the preceding sentence with respect to the portfolio of rights and obligations arising from the cleared swaps that the Collecting FCM (on behalf of the Depositing FCM) or FCM, as applicable, intermediates for each Customer.

Additions to Customer Collateral

Under Regulation 22.13, a DCO or Collecting FCM may elect to increase the collateral requirements set forth in Regulation 22.12 applicable to an individual or group of Customers, based on the credit risk posed by such individual or group. Collateral deposited by an FCM

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[10] *Regulation 22.1 defines "depositing futures commission merchant" as an FCM that carries cleared swaps on behalf of Customers through another FCM and, as part of carrying such cleared swaps, deposits Customer Collateral with such FCM.*

which is identified as such FCM's own property may be used by the DCO (or a Collecting FCM), as applicable, to margin, guarantee or secure the cleared swaps of any or all Customers. In addition, an FCM is permitted to transfer to a DCO any Customer Collateral posted by a Customer in excess of the amount required by the DCO if (a) the rules of the DCO permit such a transfer, and (b) the DCO has a mechanism by which the FCM is required to identify for each Customer, on each business day, the amount of Customer Collateral posted in excess of the amount required by the DCO. In the Release, the CFTC explains that collateral attributable to an FCM's residual financial interest is not the property of any Customer and there is no customer-protection-based reason to deny a DCO or Collecting FCM the ability to use such collateral to meet a Customer's default.

Compliance Date

The compliance date for the Part 22 Regulations is November 8, 2012.

COMMODITY BROKER BANKRUPTCY

The Final Rules amend Part 190 in order to give effect to section 724 of the Dodd-Frank Act and to provide for technical clarifications. As mentioned above, section 724(b) of the Dodd-Frank Act amends the Bankruptcy Code to clarify that cleared swaps are "commodity contracts" within the meaning of section 761(4)(F) of the Bankruptcy Code. Accordingly, in the event of an FCM or DCO insolvency, Customers may invoke certain protections,[11] including protected transfers of cleared swaps and Customer Collateral and, if cleared swaps are subject to liquidation, preferential treatment of remaining Customer Collateral. However, pursuant to section 766(h) of the Bankruptcy Code, in the event of FCM or DCO insolvency, customer property must be distributed pro rata to customers on the basis and to the extent of such customers' allowed net equity claims.

The CFTC amends its Regulation 190.01 to change the definition of "account class" to include a class for cleared swaps accounts in addition to futures accounts and other accounts. The Final Rules clarify that CFTC orders putting futures contracts and collateral in the cleared swaps account class are treated, for bankruptcy purposes, in a manner analogous to orders putting cleared swaps and Customer Collateral in the future account class. The Final Rules also clarify that if positions or transactions that would otherwise belong to one account class are, pursuant to CFTC rule or order, held separately from other positions and transactions in that account

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11 *Such protections can be found in Subchapter IV of Chapter 7 of the Bankruptcy Code.*

class and are commingled with positions and collateral in commodity contracts in another class, then the former positions and collateral will be treated as part of the latter account class.

Effective Date

The effective date of the revisions to Part 190 is 60 days after the Final Rules are published in the Federal Register. Prior to the compliance date for Regulation Part 22, the definition of "Cleared Swap" under Regulation Part 190 shall be limited to transactions where the rules or bylaws of a derivatives clearing organization require that such transactions, along with related collateral, be held in a separate account for cleared swaps only.

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